FOMC BRIEFING
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The major issue facing the Committee in its review of the ranges for 1986 is, of course, the target for, and treatment of, M1, with credit growth also presenting some questions. M2 and M3 are well within their ranges, and seem likely to remain there over the balance of the year. With respect to M1, hitting the 8 percent upper end of the current range would require growth at only around a one percent annual rate from June to December. While a spontaneous deceleration of this aggregate cannot be totally ruled out, it seems most likely that a slowing of this magnitude could only be achieved through a substantial tightening of reserve availability and rise in interest rates. Such a policy course would appear to be inconsistent with a moderate strengthening of economic activity in the second half of the year and into 1987 and perhaps with the broader aggregates remaining above the lower bounds of their ranges as well.

Absent such a tightening, another substantial decline in velocity for 1986 appears in train--marking the third year in the last five that M1 has outrun GNP by a sizable amount. Moreover, the staff forecast for 1987 involves a much more modest pick-up in GNP growth than might have been predicted based on past lagged relationships between M1 and spending, extending the period in which M1, taken by itself, has been a poor indicator of future GNP. A major reason for the deterioration of the M1-GNP relationship is the changing nature of this aggregate, resulting from deposit deregulation and the spread of cash management techniques. For one thing, these processes have left us with a great deal of uncertainty about the relationship of this aggregate to other economic variables, as evidenced by the failure of most money demand equations to explain a substantial portion of second-quarter growth. It does seem clear, however, that M1 has become more sensitive to changes in interest rates, not only in its OCD component as deregulation has proceeded, but in demand deposits as well. This latter development may reflect the shifting of household balances into OCD and the spread of cash management to smaller businesses. These businesses have been able to reduce excess cash balances, which likely were not very responsive to rate movements, and they are probably purchasing cash management services disproportionately from regional banks, which tend to emphasize payment via interest-sensitive compensating balance arrangements.

A highly interest-sensitive aggregate is a notoriously poor guide for monetary policy. The question of whether rapid growth in such an aggregate following a drop in rates will give rise to rapid income growth can not be answered without reference to the level of interest rates themselves and a judgment about their likely implications for the economy. The staff's GNP forecast suggests that the current level of rates will support a moderate pick-up in economic expansion. In that context the current decline in velocity can be viewed as representing relatively permanent additions to cash balances as interest rates have adjusted downward to levels more consistent with lower inflation and sustainable growth. The more modest rate of M2 growth also provides some comfort in this regard, by suggesting that the growth in M1 represents more a shift in the locus of savings--albeit in a more liquid and immediately spendable direction--than an overall build-up in the public's monetary assets that is likely to end up stimulating spending excessively.

The Committee has several options for dealing with M1 in this situation. One would be simply to forego setting a new range for this aggregate, announcing that it would be expected to exceed the current range, but by an unknown amount. A new range consistent with Committee objectives for the broader aggregates and the economy would be difficult to establish under circumstances of considerable uncertainty about the relationship of M1 to income and interest rates, and about the likely level of interest rates, which will importantly influence the course of M1. However, dropping the range altogether might be interpreted as implying a complete lack of concern about the growth of an aggregate that has provided a key reference point for monetary policy over the years--one that still might send important signals to the Federal Reserve and the public under certain circumstances. One possibility would be to retain the 3-to-8 percent range as a benchmark for the future, but without immediate significance in the current implementation of policy. It would signal within a very broad area the general range for M1 growth the Committee expects will be needed in attaining price stability over time--under conditions in which interest rates should be fluctuating over a narrower range and an underlying trend in velocity can re-assert itself.

Alternatively the Committee could establish a new range for M1 that was expected to be compatible with the Committee's objectives for economic performance and its targets for the other aggregates. As suggested in the bluebook, the 11 percent upper limit of alternative II could well be consistent with some pickup in GNP at current, or slightly lower interest rates. However, should interest rates need to decline substantially further to sustain GNP, M1 growth might not slow much, if at all, from the first half, and could run around 12 percent for the year. Spreads of market rates relative to those on NOW accounts already are extremely narrow, and with offering rates on these accounts apparently reacting sluggishly to declines in market rates, inflows to M1 might remain quite sizable, at least for a time, under these circumstances.

Should the Committee wish to establish a new M1 range, two related questions would need to be addressed. One would be the weight to give growth of this aggregate relative to its range in policy implementation. It could be designated "monitoring" range, similar to the status now accorded the debt aggregate. Such a designation would seem to imply that the Committee would be tracking developments in this aggregate, but under most circumstances would be unlikely to react to growth outside the new ranges. Another issue is whether to rebase to the second quarter. Certainly, a strong case can be made for "forgiving" the growth of the first half of the year. But, even if interest rates do not decline further, the period of abnormal M1 growth and declines in its velocity is probably not behind us. The staff expects rapid money growth in the third quarter on a quarterly average basis--amounting to 11-1/2 percent under alternative B--owing to the continuing effects of the recent decline in interest rates, as well as to the arithmetic effect on the third-quarter average of the rapid money growth late in the second quarter. As a result, even with rebasing, the Committee may find it has to raise the numerical range; for example, the 11 percent upper end of the alternative II range is consistent with growth of over 9 percent for the second half.

The growth of nonfinancial debt also is well above its range--though not quite to the extent of M1--and the staff projects that it will remain so for the year. Borrowing has slowed this year, but not sufficiently to offset the effects of the surge in December on growth measured from the fourth-quarter average. Underlying demands for credit apparently remain very strong and debt-to-income ratios continue to rise. The Committee could raise the range to encompass expected growth--an upper end of 12 percent might be barely sufficient--or, as it has when facing this problem several times in the last few years, the Committee could leave the range unchanged but indicate that it expected growth to run at or over the upper end. In following this latter approach in the past, the Committee has suggested that recent growth in debt is not considered consistent with economic and financial stability over time.

Turning to the tentative ranges for 1987, the question is whether and to what extent the Committee wishes to reduce the ranges relative to 1986. The bluebook presents two alternatives. Both alternatives retain the 3 to 8 percent range for M1, which would represent a substantial deceleration from growth expected this year. The level and treatment of the 1987 ranges for this aggregate might depend in part on the Committee's decision with respect to M1 for 1986. If the Committee chose to raise the 1986 range, then a higher range for 1987 might also be considered. For example, should the Committee chose a range of 5 to 10 or 6 to 11 percent for 1986, then a 4 to 9 percent range for 1987 would still convey the general intent to slow M1 growth from 1986. The 3 to 8 percent range does encompass the staff's best estimate of M1 growth of around 7 percent for 1987, but a 4 to 9 percent range would more comfortably allow for the chance of some further decline in velocity.

For the broader aggregates and credit, alternative I would carry over the 1986 ranges, while alternative II would reduce the ranges by one-half point. One wouldn't want to make too much of the differences in these alternatives--both are considered consistent with stronger economic growth accompanied by only a modest pick-up in inflation in 1987 as in the greenbook

GNP forecast--but the choice between the alternatives can be seen as related to a weighing of the risks to such an outcome, or even whether the outcome itself seems adequate.

Maintenance of the current ranges would seem more consistent with concern about the strength of the expansion. It would allow for faster growth of nominal income, perhaps permitting greater expansion of real activity in the face of some pick-up in inflation. If a weak economy were mirrored in slack demands for the broader aggregates, then the ranges of alternative I would tend to signal the need for ease more quickly than the lower ranges of alternative II. Alternative I also allows more scope for faster money growth should interest rates need to decline--and velocities with them--to maintain income in the face of weak demands.

Alternative II would be more consistent with greater emphasis on the potential for more rapid inflation. Such concerns might intensify should the dollar decline sharply further, or the economy begin to accelerate more substantially, eating into unused margins of labor and capital, and threatening wage and price pressures--if not in 1987, then beyond. Alternative II implies a bit more restraint on income growth under such circumstances, reducing the likelihood of price pressures getting built into an inflationary spiral. It would underline the Federal Reserve's often-stated belief that some slowing in money growth over time was needed to attain and sustain reasonable price stability.